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The Estonian Foundation

What is Missing for It to Be A Well-Designed Wealth-Management Vehicle for Local and Foreign High-Net-Worth Individuals?

1. Introduction

Private foundations (PFs)^{*1} ensure the undivided, secure, and profitable placement of assets, thereby offering solutions for succession and inheritance issues, concerns over wealth taxes, and matters related to the global economy, which have been identified as the three main factors threatening wealth creation both over the past 10 years and for the coming decade.^{*2}

While many countries^{*3} have chosen implementation of the Anglo-American trust to cater for these purposes, the European PF landscape too has been evolving in recent decades^{*4}. The leanings towards the PF model rather than the trust model are probably related to the PF being a more familiar and a clearer structure for civil-law countries. Many would-be settlors^{*5} may be baffled to learn that trusts do not exist as separate legal entities and that the proposed estate-planning exercise consists of an assignment of valuable and hard-earned property to a stranger, who will then hold it in his own name. Also, it might seem more secure to establish a PF, the validity of which cannot be questioned as easily as the well-developed doctrine of 'sham' trusts might allow^{*6}.

¹ Public foundations, however, operate in the public interest (e.g., with religious, scientific, artistic, educational, cultural, or charitable aims).

² Knight Frank Wealth Report 2016, p 10. Available at <http://content.knightfrank.com/research/83/documents/en/wealth-report-2016-3579.pdf> (most recently accessed on 30.3.2016)

³ These include Luxembourg, France, San Marino, Romania, Malta, and the Czech Republic in Europe, along with Quebec, Canada. One of the most recent examples is the trust model provided by Book X of the Draft Common Frame of Reference.

⁴ Whereas in Austria before 1993, foundations had no choice except to be charitable, the Private Foundations Law of 1993 enabled PFs. In Belgium, the PF was introduced in 2002, and the foundation sector in Belgium has been growing ever since. Malta enacted specific foundation legislation in 2007. The legal and tax landscape surrounding Dutch PFs dramatically changed with the introduction of a new tax doctrine on 'segregated private capital' as of 2010. Even before that, one specific foundation form, the so-called 'depository foundation' (*stichting administratiekantoor*, STAK) for the purpose of acquiring and administering assets (shares) was widely used. In Luxembourg, a draft act for the introduction of PFs was submitted to the Parliament in 2013, but it still seems to be under discussion for purposes of meeting the anti-money-laundering requirements.

⁵ The settlor is the person who sets up a trust, transfers the assets to the trustee, and determines the trust terms (the founder's equivalent).

⁶ The trust might be regarded as a 'sham' in a case wherein it is set up to harm existing creditors or with no actual change in the control of the property. In this case, it can be deemed to be void *ab initio* and brings with it adverse tax consequences as well as the exposure of the trust fund to claims by creditors, spouses, heirs, and other dependants.

Estonia has had its foundations' regulation – in the form of the Estonian Foundations Act⁷ (FA) – in place since 1995. As it does not impose specific restrictions on the purpose of foundations, they can be used for protecting private wealth or benefiting present or future generations of a family and not merely for public charitable purposes. Nevertheless, the local high-net-worth individuals (HNWIs)⁸ prefer to use schemes offered by other countries, and Estonia's export of the relevant service is a non-issue today. This article explores why this is so and proposes amendments to the current regulation that would give rise to a new wealth-management vehicle inspired by PF regimes introduced in other countries and that could be used by Estonians and foreign HNWIs alike.

2. The objectives of a PF

Worldwide, HNWIs use PFs for a large variety of purposes, the following chief among them:

- They can be used to prevent the dispersal of the estate (business) after one's death.
- They can ensure continuity in management. This could be useful when a founder has no children or if he considers some of his heirs not fit to run the business or they do not wish to do so.
- They can enable the reaching of a specific goal. The familial estate can be assigned to a specific purpose, such as providing for a relative in the case of incapacity or lack of financial maturity. For example, parents with a disabled or minor child may be concerned with who will manage their child's assets and how they will be managed upon their own death or perhaps when they themselves become disabled. Nowadays, people are tending to live longer, and there is an increase in the number of people who are affected by conditions such as dementia and Alzheimer's disease, which can result in restricted active legal capacity.
- Another purpose is to protect specific assets, as in the case of keeping the family home out of the reach of creditors. This could be especially attractive for businessmen or for those whose professions open them up to the risk of civil liability (e.g., doctors or lawyers), but in light of today's economic and financial instability – and, in some regions, political instability – it could be attractive for anyone. It should be kept in mind, though, that there are usually some specific rules protecting creditors in a case wherein a PF is set up to harm existing creditors or with no actual change in the control of the property.
- They can also be used to optimise tax liability.

As already noted, the FA does not impose specific restrictions on the purpose of a foundation and a foundation therefore could be used for public purposes as well as private ones (including all of those mentioned above).

It is possible for the founder to provide a series of provisions in the bylaws to ensure that the future functioning of the PF conforms to his wishes, including the objectives for the PF, the (set of) beneficiaries, and provisions for the dissolution of the PF⁹. A foundation does not have members, and the law excludes transfer of the founder's rights to successors. The participation of the beneficiaries in a PF's management board is prohibited, and it can also be ruled out at the level of the supervisory board. In a nutshell, the PF provides a possibility of 'locking' the property in a separate vehicle on the operation of which third parties have no direct impact. Other forms of legal entity – such as private limited companies – do not provide quite the same solution.

Nevertheless, much of the regulation in the FA seems to be inspired by times when foundations were used only in the public interest, which supposedly required stricter public control options.

⁷ Sihtasutuste seadus. – RT I 1995, 92, 1604; 30.12.2015 (in Estonian). English text available at <https://www.riigiteataja.ee/en/eli/504022016004/consolide> (most recently accessed on 30.3.2016).

⁸ HNWIs are defined as those persons having investable assets of US\$ 1 million or more, excluding their primary residence and collectibles, consumables, and consumer durables.

⁹ The mandatory provisions are listed in §8 (1) of the FA, but under §8 (2) of the FA, the bylaws may prescribe other conditions that are not contrary to the law. Under §40 (2) 3) of the FA, any further changes in the bylaws must be consistent with the objectives of the PF.

3. Publicity

One of the biggest problems affecting Estonian PFs is the lack of privacy: the information on a PF is available to everyone from the register.

According to §6 (1) of the FA, the foundation resolution shall set out the data (name, address, etc.) pertaining to the foundation, along with the founders, the members of the management/supervisory board, and the assets to be transferred to the foundation by the founders.

Under §8 of the FA, other terms shall be set forth in the bylaws: the objectives; the (set of) beneficiaries; the distribution of the assets of the foundation upon dissolution of the foundation; the procedure for appointment and removal of members of the management/supervisory board, along with their term of office; the procedure for amendment of the bylaws; the conditions for dissolution of the foundation; the remuneration of the board members; the procedure for use and disposal of assets; and any other conditions provided by law or that are not contrary to the law. This also means that the conditions for how the distributions to the beneficiaries are to be made or the requirements/exclusions for board members must be laid out in the bylaws, as the FA does not foresee the possibility of a separate 'letter of wishes'*¹⁰.

After the PF is registered, both of the above-mentioned documents (the resolution and the bylaws) are accessible to anyone (for a fee of two euros) from the register of not-for-profit associations and foundations.

In addition, the undefined terms 'interested person' and 'person with a legitimate interest' pop up here and there in the FA. For example, a 'person with a legitimate interest' may, pursuant to §39 of the FA, demand information from a foundation, including the information pertaining to fulfilment of the objectives of that foundation, the sworn auditor's report, and accounting documents. Subsection 39 (2) of the FA grants the same right to 'all interested persons' if the bylaws do not determine a set of beneficiaries. Presumably, those terms refer to persons whose rights would be affected by the activities of the foundation or its board members and are not meant to satisfy plain curiosity; nevertheless, these provisions would need a reassessment if the regulation of PFs is to be improved.

Furthermore, under §34 (4) of the FA, Estonian PFs have to submit annual accounting reports to the register, and these, too, are publicly available from the register. Hence, everybody can access all the information pertaining to the financial situation, economic performance, and cash flows of any PF. An audit of the annual accounts is compulsory on certain conditions*¹¹.

If we look at other countries' PF regulations, we can see that they offer more privacy.

In Austria, the declaration of establishment can be split into two documents: the statutes and the bylaws.*¹² The nomination of beneficiaries and giving directions as to distributions to be made to the beneficiaries can be settled in the bylaws, which are not open to the public for inspection.*¹³ However, if the PF is to qualify for tax advantages, the documents must still be disclosed to the Austrian tax authorities.*¹⁴

Austrian PFs are subject to bookkeeping and financial reporting in the same manner as a corporation, but the public has no access to the reports of a PF and only the tax authorities are aware of its income, wealth, and assets.*¹⁵ A PF is, however, subject to an annual audit by an independent professional auditor, who has to assess whether the PF's activities have been in line with its purpose as stated in the PF documents whether its funds have been managed properly and wisely, whether all housekeeping tasks have been correctly performed, and whether the PF is fully compliant with the law (including tax regulations). The auditor is also to review the PF's compliance with the anti-money-laundering (AML) rules.*¹⁶

¹⁰ Which, in the case of trusts (and in some countries, PFs too), is an indication by the settlor of the manner in which he wishes the trustees to exercise their discretion in relation to a trust.

¹¹ See §91 (2) 4) of the Auditors Activities Act (Audiitortegevuse seadus. – RT I 2010, 9, 41; 30.12.2015, 8 (in Estonian)). English text available at <https://www.riigiteataja.ee/en/eli/504022016002/consolide> (most recently accessed on 30.3.2016).

¹² M. Petritz, A. Kampitsch. Austria: The Austrian private foundation. – *Trusts & Trustees* 20/6 (July 2014), pp. 543–544. – DOI: <http://dx.doi.org/10.1093/tandt/ttu075>.

¹³ F. Schwank. The Austrian private foundation as a holding structure for global family wealth. – *Trusts & Trustees* 20/1–2 (February–March 2014), p. 173. – DOI: <http://dx.doi.org/10.1093/tandt/tt247>.

¹⁴ Hasch & Partner Anwaltsgesellschaft mbH. The Austrian private foundation: A brief guide for the investors, p. 4. Available at http://hasch.eu.dedi2098.your-server.de/files/channels/publikationen/Austrian_Private_Foundation_Brochure_E_.pdf (most recently accessed on 30.3.2016).

¹⁵ F. Schwank. The Austrian private foundation: Between transparency and bank secrecy. – *Trusts & Trustees* 16/6 (July 2010), p. 418. – DOI: <http://dx.doi.org/10.1093/tandt/ttq059>.

¹⁶ *Ibid.*, p. 416.

In Belgium, the bylaws of a PF are public^{*17}, but the accounting obligations depend on the size of the foundation^{*18}, which also determines where the relevant information has to be filed, as there is no central database for the foundation sector^{*19}. Only 'large'^{*20} foundations are to be audited.

In Malta^{*21}, the Netherlands^{*22}, and Luxembourg^{*23}, there is no disclosure of founder or beneficiary names, the PF deeds are not public, and there is no need for annual reporting. However, the final version of Luxembourg's draft law for PFs might come with some changes to reflect the requirements of the Fourth Anti-Money Laundering Directive^{*24}.

The directive, which must be transposed by 26 June 2017, focuses specifically on enhancement of beneficial ownership's transparency. In short, it requires Member States to establish central registers for the information on ultimate beneficial owners (UBOs). The UBOs in the case of trusts and PFs^{*25} are the settlor/founder, the trustee/administrator(s), the protector(s) (presumably, one or more members of the supervisory board in the case of PFs), the beneficiaries (or, if not determined by name, the class of persons in whose main interest the legal arrangement or entity is set up or operates), and any other natural person exercising ultimate control over the trust – whether by means of direct or indirect ownership or by other means.^{*26}

This information must be accessible to competent authorities; financial intelligence units; and, as part of customer due diligence, obliged entities (such as banks or notaries). Persons who can demonstrate a legitimate interest are to have certain access rights too (Art. 30(5)). The threshold laid down by the directive on 'legitimate interest' is that that interest must be related to money laundering, terrorist financing, or the related basic offences – such as fraud and corruption. Journalists are expected to be included in this group.^{*27} This has opened up a heated debate about privacy. In a PwC study addressing the impact of the UBO register, the following has been stated:

It goes without saying that the interests of those involved may be seriously prejudiced by the careless or incompetent processing of personal details [...]. [E]ntrepreneurial and high-net-worth families fear that the public information will lead to undesirable mentions on 'lists of millionaires' and the not-inconceivable risk of blackmail, violence, intimidation, kidnapping or fraud. This is particularly so in the case of minors or other vulnerable individuals.^{*28}

When we bear this in mind, it seems even more unacceptable that in Estonia excessive information related to PFs is open for everyone. And it is not surprising that people are choosing other countries for private

¹⁷ A. van Zantbeek, J. Drayey. The Belgian private foundation. – *Trusts & Trustees* 16/6 (July 2010), p. 511. – DOI: <http://dx.doi.org/10.1093/tandt/tts052>.

¹⁸ O. Farny, et al. Taxation of foundations in Europe, p. 12. Available at https://media.arbeiterkammer.at/wien/PDF/studien/Studie_Stiftungsbesteuerung_in_Europa_englisch.pdf (most recently accessed on 30.3.2016).

¹⁹ V. Xhaufclair, et al. Belgium Country Report, EUFORI Study, p. 10. Available at <http://euforistudy.eu/wp-content/uploads/2015/07/Belgium.pdf> (most recently accessed on 30.3.2016).

²⁰ PFs that fulfil one or more of the following three criteria: 50 full-time staff, EUR 6,250,000 in annual revenue, and EUR 3,125,000 in total assets. – see Farny et al. (see Note 18), p. 10.

²¹ A. Cremona. Malta: Foundations – the new vehicle of choice? – *Trusts & Trustees* 16/6 (July 2010), p. 481. – DOI: <http://dx.doi.org/10.1093/tandt/ttq046>.

²² M. Vogel. The Dutch foundation: The solution in tax planning, estate planning and asset protection for high net worth individuals worldwide. – *Trusts & Trustees* 21/6 (July 2015), pp. 686–690. – DOI: <http://dx.doi.org/10.1093/tandt/ttv067>; M. Bergervoet, J. Starreveld. How private is the Curaçao private foundation, Curaçao trust, and the Dutch private foundation? – *Trusts & Trustees* 19/6 (July 2013), pp. 577–583. – DOI: <http://dx.doi.org/10.1093/tandt/ttt080>.

²³ Luxembourg's draft law for introducing the PF did not require the names and details of the founder(s), the beneficiary/beneficiaries, and the assets allocated to the PF to be published or disclosed. Some changes might be visible in the final act, however, as it is being amended to reflect the requirements of AML regulations. See C.N. Kossmann. 'Luxembourg: The Luxembourg Patrimonial Foundation: what's new in Luxembourg?' – *Trusts & Trustees* 21/6 (July 2015), pp. 679–680. – DOI: <http://dx.doi.org/10.1093/tandt/ttv056>.

²⁴ Directive (EU) 2015/849 of the European Parliament and of the Council of 20 May 2015 on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing, amending Regulation (EU) No. 648/2012 of the European Parliament and of the Council, and repealing Directive 2005/60/EC of the European Parliament and of the Council and Commission Directive 2006/70/EC. – OJ L 141, 5 June 2015.

²⁵ In the case of foundations the natural person(s) holding positions equivalent or similar to those referred to in the case of trusts are deemed to be the UBOs, under Article 3 (6) (b) (c) of this directive.

²⁶ Please see Note 25 above.

²⁷ PwC Netherlands. Finding a balance between transparency and privacy – a study of the impact of the UBO register on high-net-worth families and family businesses in twelve European countries, p. 10. Available at <https://www.pwc.nl/en/assets/documents/pwc-finding-a-balance-between-transparency-and-privacy.pdf> (most recently accessed on 30.3.2016).

²⁸ *Ibid.*, p. 16.

wealth-management purposes. Publicity on that level could be explained in the case of foundations with a public purpose (charities) that have external donors or maybe in cases in which a foundation has engaged heavily in business activities (to protect possible creditors), but in cases of a classical family foundation with an objective of holding property, it raises the question of whether there are third parties actually needing that kind of protection.

The third parties' rights might come under discussion when a transfer of assets is made to the PF to defraud or prejudice creditors, is made within a specified period before the transferor becomes bankrupt, is made with intent to defeat a claim for financial relief upon divorce, or is made for purposes of getting around fixed or discretionary family-protection rules pertaining to a donor's family and dependants after his or her death. But even in those cases, there is probably no need for everyone to access the PF's terms and documents, income details, and asset information – it would be enough if certain public authorities and interested persons (in a narrower sense) were to have the right. What might need reconsidering in updating of the PF regulations is whether the current regulations and rules on conflict of laws pertaining to the above-mentioned situations are sufficient: the provisions regulating recovery (or 'clawback') in bankruptcy law, gifts made to a third party with the purpose of causing damage to a person entitled to claim a compulsory portion in succession law, setting aside of transfers on the grounds of ostensibility or conflict with good morals or public order (see §89 and §86 of the General Part of the Civil Code Act^{*29}, or GPCCA), and grounds for the compulsory dissolution of a foundation (see §40 of the GPCCA and §46 of the FA).

4. Bodies of a foundation: Two boards, four people

Another thing that needs reconsideration is the number of persons and organs required to run a PF. At the moment, §16 of the FA foresees two mandatory organs: the management and the supervisory board. According to §17 (7) and §18 (3) of the FA, the management board manages and represents the foundation but has to adhere to the lawful orders of the supervisory board. The management board may consist of one or several members, who must be natural persons. Subsection 17 (5) of the FA prohibits beneficiaries or persons with an equivalent economic interest from being members of the management board. Also, a member of the supervisory board shall not be a member of the management board (under §17 (6) of the FA).

According to §24 of the FA, the supervisory board plans the activities of the foundation, organises the management of the foundation, and supervises the foundation's activities. Subsection 26 (1) of the FA foresees that the supervisory board must have at least three members (again, natural persons). The founder and the beneficiaries can be members of the supervisory board (if this is not prohibited by the bylaws).

Consequently, the founder has to find at least three trustworthy persons (in addition to himself) – one to be a member of the management board and three for the supervisory board – to set up a PF. For a small family-wealth-protection vehicle, this might be too much.

In Malta, only the board of administrators is mandatory. The founder is the one who may exercise supervision over the administration of the PF. He is also entitled to intervene in the appointment of administrators or in the disposal of the assets, when a court is dealing with these issues. Administrators of a PF may be either natural or legal persons. In the latter case, there must be at least three directors. Administrators do not need a licence to act as such. A founder may be an administrator of a foundation and may also be a PF's beneficiary within his lifetime: if the founder is a beneficiary, that founder may not, at the same time, act as the sole administrator of the PF. The terms for the PF may provide for the establishment of a supervisory council consisting of at least one member or for the office of one or more protectors with similar functions.^{*30}

In Belgium, having a supervisory board is not mandatory, but a PF must have at least three directors (either individuals or legal entities).^{*31} The existence of a supervisory board is voluntary also in the Netherlands.^{*32}

²⁹ Tsiviilseadustiku üldosa seadus. – RT I 2002, 35, 216; 01.10.2015 (in Estonian). English text available at <https://www.riigiteataja.ee/en/eli/528082015004/consolide> (most recently accessed on 18.6.2016).

³⁰ J. Scerri-Diacono. Malta: A synopsis of the basic rules regulating private foundations. – *Trusts & Trustees* 14/5 (June 2008), pp. 320–333. – DOI: <http://dx.doi.org/10.1093/tandt/ttn029>.

³¹ A. van Zantbeek, J. Drayey (see Note 17), p. 510.

³² M. Vogel (see Note 22), p. 686.

In Austria, the board of directors has to consist of at least three members. The founder normally appoints the members of the board in its initial composition, and the court subsequently appoints any new members. A (current) beneficiary, a spouse or partner thereof, other relatives (as far as the third degree), and legal persons may not be members of the board. The founder is not generally excluded from membership of the board unless he is a current beneficiary. A supervisory board is mandatory only if the PF has more than a certain number of employees^{*33}.

Under the draft law of Luxembourg, one or several directors manage the PF. A supervisory board becomes mandatory if the PF has more than five beneficiaries or if its assets exceed 20,000,000 euros. The same person can be founder, beneficiary, and manager. A manager cannot be a member of the supervisory board.^{*34}

In reconsideration of the necessity of the two-tier structure and the number of people involved, the rights and obligations of the current two boards and requirements imposed on the board members certainly need some reassessment too. For example, to ensure that the assets are managed professionally and profitably even when there is only one person to manage the PF, it is possible to foresee certain requirements as to the skills and personal qualities possessed by a board member. Different solutions can be developed for different cases: for example, that a requirement for a three-member supervisory board should apply only to a foundation whose assets exceed a certain threshold. And, as mentioned above, there already exists the notion of 'interested persons', who have several opportunities to turn to the courts to exercise control over the activities of the foundation: for instance, an interested person can request the court to decide on replacement of a member of the management/supervisory board^{*35}, and, according to §38 (1) of the FA, an interested person may also request conducting of a special audit to address matters related to the management or financial status of the foundation.

5. The problem of double taxation

Next, we will analyse the main problems surrounding the current taxation of PFs in Estonia and suggest solutions.

In practice, PFs are often used for holding shares of a company, exercising shareholders' rights, and passing on the dividends received to the beneficiaries.

When an Estonian company pays dividends (or makes payments from the equity of the company, liquidation proceeds, or other sources listed in §50 (2) of the Income Tax Act (ITA)), it has to pay income tax.^{*36} According to §50 (1¹) and §50 (2¹) of the ITA, no income tax is to be charged if the parent company of the relevant company makes further distributions from that profit. These exemptions cannot be applied to a foundation, as it does not have owners and the payments cannot be regarded as dividends or any other type of payments from equity. There is no fundamental difference in the case of the PF owning shares of a non-Estonian legal entity, as non-resident companies also normally pay taxes in their countries of tax residency before transferring dividends to the PF. Hence, a second taxation of the relevant income takes place when the PF transfers funds to beneficiaries. It is not entirely clear how the payment should be defined under the ITA, but there are two options: it is more likely that the payment should be regarded as a gift (which under §49 (1) of the ITA is taxable if made by a legal entity). The second alternative would be to define the payment as an expense not related to business or activities specified in the bylaws and tax it accordingly (under §51 (3) of the ITA). Under both options, there is no further taxation if the beneficiary is a resident natural person (see §12 (2) and §19 (3) 6) of the ITA). When the beneficiary is a non-resident, further taxation depends on the country of residence.

³³ C. Prele (ed.). *Developments in Foundation Law in Europe*. Springer Netherlands 2014, p. 16. – DOI: <http://dx.doi.org/10.1007/978-94-017-9069-7>.

³⁴ Ogier Law Firm. Luxembourg private foundation. Available at <https://www.ogier.com/publications/l-luxembourg-private-foundation> (most recently accessed on 30.3.2016).

³⁵ If there is good reason – consisting, above all, in failure to perform a board member's duties to a material extent, inability to participate in the work of the supervisory board, or significant damaging of the interests of the foundation in any other manner – according to §28 (1) 3) and §20 of the FA.

³⁶ Tulumaksuseadus, §50 (1). – RT I 1999, 101, 903; 17.12.2015, 2 (in Estonian). English text available at <https://www.riigiteataja.ee/en/eli/ee/530012014003/consolide/current> (most recently accessed on 30.3.2016).

When a PF sells shares of a company and subsequently distributes the gains to beneficiaries, taxation of the distribution takes place in the same way as in the example above. As the gain is already taxed at the level of the investee, double taxation takes place here also, and the same problem is applicable for companies^{*37}.

The solution for resolving the first issue would be to treat distributions to PF beneficiaries made in accordance with the bylaws as if they were dividends of a company. With this approach, all exemptions that are applicable to dividends would be applicable also to payments to beneficiaries from the profits. Payments to third parties or expenses not related to activities specified in the bylaws would be treated in the way they are now.

To eliminate double taxation of the gains from sales of shares or other securities of entities, another exemption should be added to §50 (1¹), stating that income tax is not to be charged on dividends if the dividend is paid out of the profit attributable to sales of shares or other securities of an entity that is not registered in a low-tax-rate territory^{*38}.

Another issue is the distribution of endowments to beneficiaries. Payments of this nature are currently taxed similarly to payments from dividend income, as described above. However, there is no gift or inheritance tax in transactions between natural persons^{*39}, and when a company decreases its share capital and distributes the funds to owners, no tax is charged on the portion not in excess of the contributions made to the equity of the company. Hence we propose clarifying that distribution of endowments to beneficiaries would not trigger tax for a PF or beneficiary.

The above-mentioned solutions are proposed in light of the current Estonian regulation under which a foundation is liable for tax in its own right. But in other European countries we can find a different approach, wherein PFs are regarded as tax-transparent and the tax liabilities are imputed to the beneficiaries (or founder). This has been called the 'look-through' approach. In that case, the PF itself is not regarded as a tax resident of the country where it is registered, and double taxation treaties do not apply to it.^{*40} The tax obligations of the beneficiaries (and, in some cases, the founder) depend on the regulations of their respective home countries. This is why the 'look-through' approach seems preferable especially when the founder and/or beneficiaries are not residents of the country where the PF is registered: the taxation system might be easier to understand. When a tax-transparent PF is established, a tax-resident holding company is usually established too, in the same country, to benefit from the double taxation treaties. Usually, in application of the 'look-through' approach, the PF is not permitted to be engaged in trading and other business activities.^{*41} In some countries, such as Malta^{*42}, it is possible for the PF to decide which approach – being considered tax-transparent or instead an opaque entity – it wants to be applied. A PF wishing to engage in normal business activities would select the company taxation approach, and a PF that would be interested mainly in focusing on family wealth-protection would choose the 'look-through' approach. The choice of one or the other option might also be informed by differences in tax consequences for founders and beneficiaries in their countries of residence.

We propose that Estonia too introduces legislation enabling PFs to select an option of tax-neutral and transparent treatment (and thereby be exempt from corporate taxation) at the moment of establishment. In this case, the income of the PF would comprise only royalties, dividends, capital gains, interest, rent, or other passive income, since the PF would be prohibited from trading or business. The decision would be irrevocable; i.e., it could not be changed within the lifetime of the PF.

³⁷ See E. Uustalu. Põhimõtteline muudatus maksusüsteemi konkurentsivõime suurendamiseks: vabastame osaluste võõrandamise topeeltmaksustamisest ['A fundamental change in the tax system to increase competitiveness: Getting rid of the double taxation of transfer of shares']. – *MaksuMaksja* 2008/4 (in Estonian). Available at <http://www.maksumaksjad.ee/modules/smartsection/item.php?itemid=730> (most recently accessed on 30.3.2016).

³⁸ For the definition of a low-tax-rate territory, see §10 of the ITA.

³⁹ However, we need to take into account that the acquisition cost for the beneficiary is zero and there could be tax consequences at the point of sale of the asset (e.g., with respect to real estate and investments).

⁴⁰ OECD Model Convention with Respect to Taxes on Income and on Capital, 2014, Article 1 and Article 4(1). Available at <https://www.oecd.org/ctp/treaties/2014-model-tax-convention-articles.pdf>, (most recently accessed on 31.3.2016).

⁴¹ See, e.g., M. Vogel (see Note 22), p. 689.

⁴² Section 27D.(1)(b) of the Maltese Income Tax Act, passed on 1.1.1949 and last amended on 15.3.2016. Available at <http://www.justiceservices.gov.mt/DownloadDocument.aspx?app=lom&itemid=8658> (most recently accessed on 31.3.2016).

In addition, the ITA needs to clarify that:

1. the PF itself is not a taxpayer^{*43}
2. distributions received from a PF will be tax-exempt for resident^{*44} beneficiaries (to avoid double taxation) in the event that:
 - a) the payment is made on account of the founder's endowments,
 - b) the payment is made on account of dividend or other income from which distributions are not (double-)taxed for companies under §50 of the ITA, and
 - c) the payment is made on account of gains from sales of shares or other securities
3. in all other cases, including those of interest, rental, and royalty income that will not be taxed on PF level, the PF follows the withholding rules specified in §§ 41–43, with account taken of the income tax paid or withheld abroad in accordance with §45.

6. Economic considerations

Next, we should ask why a legislator would favour the establishment of PFs and hence make the necessary changes. If we look again at the other countries, we find that the political rationale behind PFs has been based on three ideas: promoting the flow of domestic capital back in from abroad, preventing domestic capital from becoming capital outflow, and promoting the inflow of foreign capital.^{*45}

What would be the financial benefits for Estonia (the annual effect on GDP and the state budget) from non-residents starting to use Estonian PFs? We assume that most of these PFs would not be involved in trading and other active business, so a tax-neutral taxation approach would be applied and they would not pay income tax in Estonia.

The main target markets for Estonian PFs would assumedly be Europe, Russia and the other CIS states, and Turkey, and the target client group would be HNWIs with more than \$10 M of investable assets (multimillionaires). Current numbers indicate that there are 145,000 multimillionaires in the countries mentioned above, and the forecast for 2025 is 192,000.^{*46} In 2011, there were 725 PFs in Belgium^{*47} and 2,881 in Austria^{*48}. In 2009, Dutch trust firms served about 16,400 clients (though not all were related to HNWIs), who together held about 20,100 legal entities; that is, on average, 1.2 legal entities per client.^{*49} Hence, it is reasonable to assume that at least 20% of PF founders also establish a holding company. Proceeding from the above, we offer the conservative estimate that Estonia can attract only 1,000 PFs and assume that 20% establish a holding company. All told, we would have 1,200 entities. Current prices for domiciliation, management, and accounting services start at 7,200, including VAT, per entity.^{*50} From a survey of the Dutch trust industry examining the amount of other services (legal, auditing, etc.), these entities' needs come to around 70% of the amount for trust services.^{*51} Hence, the total fees could easily be around 15,000,000 euros ($7,200 \times 1,200 \times 1.7 = 14,688,000$). To calculate the potential tax revenue for the state budget, we can use the latest officially available figure for total tax revenues as a percentage of GDP: 32.5%.^{*52} That points to potential for an additional 5 million euros for the state budget.

⁴³ Within the meaning of §2 of the ITA.

⁴⁴ In the case of the beneficiary being a non-resident, further taxation depends on the country of residence.

⁴⁵ H. Schneider, R. Millner, M. Meyer. Austria Country Report, EUFORI Study, p. 6. Available at <http://euforistudy.eu/wp-content/uploads/2015/07/Austria.pdf> (most recently accessed on 30.3.2016).

⁴⁶ Knight Frank Wealth Report (see Note 2), pp. 64–65.

⁴⁷ V. Xhaufclair *et al.* (see Note 19), p. 7.

⁴⁸ H. Schneider *et al.* (See Note 45), p. 8.

⁴⁹ P. Risseuw, R. Dosker. *Trust Matters: The Dutch Trust Industry Revisited*. Amsterdam: SEO Economic Research 2011, p. 8.

⁵⁰ According to the Henley Business Service (Estonia) OÜ and Prospera Eesti OÜ price lists.

⁵¹ P. Risseuw, R. Dosker (see Note 49), p. 12.

⁵² European Commission. European Statistical System (Eurostat). Tax Revenue Statistics, Table 1: Total tax revenue by country, 1995–2014 (% of GDP). Source: Eurostat (gov_10a_taxag). Available at http://ec.europa.eu/eurostat/statistics-explained/images/c/ca/Total_tax_revenue_by_country%2C_1995-2014_%28%25_of_GDP%29.png (most recently accessed on 31.3.2016).

In the calculation above, we have excluded additional service fees such as the state fee and service fees for establishing a company in Estonia and other revenue following from HNWI visits to Estonia (e.g., airport fees and costs of accommodation and restaurant services).

If all the obstacles described in this article were removed from the current legislation, would there be any additional advantages to foreign HNWIs in choosing Estonia for establishing a PF? The country's financial and political stability probably are important, as is the fact that Estonia does not have an 'offshore' reputation. The existence of e-residency⁵³, which enables establishing and running a legal entity location-independently, might also be of help. Finally, in comparison to other countries, the prices of the related services are probably somewhat lower.

7. Conclusions

So, what is missing that would make the Estonian foundation a well-designed wealth-management vehicle for private purposes?

One of the biggest problems certainly is the current double taxation of PFs. Firstly, the exemptions designed for companies' use to avoid double taxation of distributions made from already taxed income (such as dividends) do not apply. Another problem is the taxation of payments made on account of gains from sales of shares or other securities (the same problem exists for companies). We have described two approaches here – a 'look-through' approach, for PFs that are not engaged in business activities, and another approach, which brings the taxation of PFs closer to that of companies – and suggested a solution under which it would be possible for each PF to choose the approach it wants to be applied.

Another major problem is the excessive accountability and publicity now involved: An Estonian foundation is registered in a public register from which the information on that foundation is accessible to everyone. This includes the data on the founder and beneficiaries; the content of the bylaws; and, through annual reports, information on the foundation's income, wealth, and assets. If we look at other countries' PF regulations, we can see that they offer more privacy and that, even though international AML regulations are moving in the direction of greater disclosure, our regulation still is disproportionate. There is no need for everyone to access a PF's terms, documents, income details, and asset information – it would be enough if certain public authorities and interested parties (in a narrower sense) were to have this right.

The authors also question the necessity of the current two-tier structure and the number of people involved in operating a PF. A general suggestion would be that whether certain elements are of a mandatory nature could be tied to the type of activities or the economic indicators of the PF.

In order to justify the necessary legislative amendments, the authors suggest some financial incentives for encouraging the establishment of PFs in Estonia by foreign founders: in the main, the estimated addition to the GDP would be 15,000,000 euros per year. For the founders, the advantages of Estonia would probably consist of our financial and political stability, the country's non-offshore reputation, the existence of e-residency, and lower establishment and management costs relative to other PF jurisdictions'.

⁵³ A digital identity that enables foreigners to use Estonian electronic services. For information on the concept of e-residency see, for example, T. Kotka, C. Vargas, K. Korjus. Estonian e-residency: Redefining the nation-state in the digital era. Oxford Cyber Studies Programme Working Papers Series, No. 3, Sept. 2015. More information about e-residency is available at <http://e-residency.gov.ee/> (most recently accessed on 30.3.2016).